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Supreme Court of the United States.

October Term, 1948.

ELMER H. BARTLETT et al.,
petitioners,

v.

DENIS W. DELANEY, Collector, et al.,
respondents.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE FIRST CIRCUIT
AND
BRIEF IN SUPPORT OF THE PETITION.

EDWARD C. THAYER,
Attorney for Petitioners.

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Supreme Court of the United States.

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ELMER H. BARTLETT et al.,
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v.
DENIS W. DELANEY, Collector, et al.,
respondents.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE FIRST CIRCUIT.

To the Honorable the Justices of the Supreme Court of the United States:

The petitioners, Elmer H. Bartlett and Philip R. Allen, pray for a writ of certiorari to review the judgment of the Court of Appeals for the First Circuit entered March 23, 1949, in the case between the above-named parties, consolidated and docketed as a single case therein as No. 4334.

Opinions Below.

The findings and opinion of the District Court are reported in 75 Fed. Supp. 490, and printed in the Record, pp. 16-26. The opinion of the Court of Appeals is reported in 173 F. (2d) No. 5, 535. It is printed in the Record, pp. 59-71.

Jurisdiction.

This Court has jurisdiction under United States Code, Title 28, Section 1254.

This application is made within the ninety-day period required by Section 2101.

Question Presented.

Where an amount of interest wrongfully exacted from a cash basis taxpayer in 1942 (the Court of Appeals having so decided in that year in a parallel case) and deducted on the return for 1942 is refunded in 1943 and included as income in the return for 1943, can the taxpayer, no statute of limitations having run, by claim for refund under Section 322 correct such errors so as to reflect the true periodic annual income?

Statutes Involved.

The statutes involved are the Internal Revenue Code, Section 322, relating to overpayments and claims for refund thereof by taxpayers, Section 43 relating to periods for which deductions are taken, and the Current Tax Payment Act of 1943, Section 6, providing for relief from double payments. The relevant parts of these sections are set out in the appendix (*infra,* pp. 17-18).

Statement.

The taxpayers have been on a cash receipts and disbursements basis, with the calendar year as their accounting period. In 1937 they received certain shares of preferred stock in Bird & Son, inc., pursuant to a recapitalization of the company. In 1942 the Commissioner asserted that

these shares constituted taxable dividends to the recipients, and determined deficiencies in their 1937 income taxes accordingly. These deficiency taxes, with interest thereon, were assessed and collected in 1942. In their respective income tax returns for 1942 the taxpayers took deductions from gross income for interest paid by them to the government in that year on the aforesaid 1937 deficiencies.

However, litigation instituted by another stockholder of Bird & Son, inc., similarly situated, resulted in a decision by the Circuit Court of Appeals for the First Circuit, rendered June 24, 1942, holding that the said issue of preferred stock by Bird & Son, inc., in 1937, did not constitute a taxable dividend. *Bass* v. *Commissioner*, 129 F. (2d) 300.

On the basis of the decision in the *Bass* case, the taxpayers, later in 1942, filed their claims for refund of the amounts of the aforesaid deficiency taxes, and interest thereon, previously paid by them. The Treasury in 1943 refunded the amounts of deficiency tax and interest thereon claimed, together with interest on the amounts refunded. In their income tax returns for the calendar year 1943, the taxpayers reported as interest income not only the item of interest which the government had paid them on the amounts refunded, but also the item of interest which they had paid on the asserted deficiency tax in 1942, which interest had been refunded to them in 1943 along with the principal amount of the deficiency tax.

The taxpayers, in September, 1944, filed their claims for refund of the respective amounts of overpayment computed by them to have resulted from the inclusion in gross income, in their returns for 1943, of the interest payments which had been refunded to them in 1943. In making such computation under the Current Tax Payment Act of 1943, each of the taxpayers adjusted the 1942 component of his 1943 income tax liability by eliminating the amount which had been deducted in his original return

for 1942 for interest paid in that year. Said refund claims thus reflected the taxpayers' true liability as prescribed by Congress, computed in the same manner as that of other shareholders in Bird & Son, inc. The Commissioner having failed to forward the statutory notice of disallowance of the claims within six months (Section 3772(a)(2), Int. Rev. Code), the taxpayers commenced the present suits for refund. The District Court entered judgments for the defendants, and the taxpayers appealed.

On appeal the judgments of the District Court were affirmed, the Court stating (R. 57) that the cases would be decided in favor of the petitioners if it adhered to its decision in *Leach* v. *Commissioner*, 50 F. (2d) 371, but that (R. 65) the rule of tax accounting applied in the Leach case was no longer tenable in view of the decision of this Court in *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281.

Specification of Errors.

The Court erred in deciding that Section 322 does not accord to the taxpayers the right to have their income correctly determined on an annual periodic basis; in extending the decision of this Court in *Security Flour Mills* to a question which was not before the Court and was not decided in that case; and in refusing to recognize that the decision below is in conflict with *Cooperstown Corp.* in the Third Circuit (which was decided after and in the light of *Security Flour Mills*).

Reasons for Granting the Writ.

1. Basic Revenue Law is involved. Section 322 in express language confers upon all taxpayers without qualification the right to correct errors in the reporting of income or the claiming of deductions so as to have their in-

come correctly determined on an annual periodic basis as provided by Section 43. A decision which qualifies this right (no period of limitations being involved) raises a point of great importance in the administration of the revenue laws.

2. *Security Flour Mills* is misconstrued. There is no similarity between

(*a*) On the cash basis, correcting an error in a statement of periodic income; and

(*b*) On the accrual basis, permitting a deduction to be taken in a year before that in which it accrued, in the sense that it became fixed and permanent.

We submit that the denial of proposition (*b*) above was the point, and the only point, decided by this Court in *Security Flour Mills*.[1] Nevertheless, the Court below felt that the *Security Flour Mills* decision compelled it to deny the correction of errors per proposition (*a*) above and to reject its decision in the *Leach* case. It does not appear that this Court has ever passed upon proposition (*a*), at least in the sense of deciding that Section 322 did not give all taxpayers the right (and Section 271 gives a corresponding right to the Commissioner) to correct an error in a statement of periodic income. *Security Flour Mills* is not such a decision. The question of whether this Court would make such a decision or intended to so suggest in *Security Flour Mills* is of general and continuing importance,[2] and we submit should be resolved by this Court.

3. The decision of the Court of Appeals for the Third Circuit in *Cooperstown Corp.* v. *Commissioner* (C.C.A. 3), 144 F. (2d) 693, is squarely in conflict with the decision of the Court of Appeals in this case. That case involved a cash basis taxpayer, the deduction in 1937 of a capital stock tax,

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[1] *Security Flour Mills* is analyzed in the brief (*infra*, p. 9).

[2] This is discussed in the brief (*infra*, pp. 12 *et seq.*).

and the refund thereof as an overpayment in 1939. The taxpayer returned the refunded tax as income for 1939. The Commissioner required, however, that, since the taxpayer was not liable for the tax in 1937, the deduction should be disallowed and a deficiency for 1937 determined. The Board of Tax Appeals in a memorandum opinion sustained the Commissioner. The appeal was argued before the Circuit Court of Appeals for the Third Circuit on January 5, 1943, and decided January 19, 1944, affirming the Board of Tax Appeals. Subsequent to the decision in the *Security Flour Mills* case (February 28, 1944) the case was ordered reargued on April 3, 1944, in the light of the *Security Flour Mills* decision. The decision was reaffirmed on August 30, 1944, the Court giving careful consideration to the *Security Flour Mills* decision and concluding that its proper construction did not affect proposition (*a*) above, but only proposition (*b*).

Freihofer Baking Co. v. *Commissioner*, 151 F. (2d) 383, referred to in the opinion below (R. 66), was decided in the Third Circuit in 1945 after the *Cooperstown* case. Like the *Security Flour Mills* case, the *Freihofer* case was a straight proposition (*b*) case and was decided in the same manner. Although the *Cooperstown* case is mentioned, there is not a word in the decision which indicates that the Court of Appeals felt that there was any inconsistency between the two cases, or that the denial of proposition (*b*) was inconsistent with the affirmance of proposition (*a*).

We urge that the writ issue to resolve such conflict and to bring about an authoritative decision by this Court of the important question involved.

Respectfully submitted,

EDWARD C. THAYER,
Attorney for the Petitioners.

BRIEF IN SUPPORT OF THE PETITION.

1. A Review of Lower Court Decisions Prior to Security Flour Mills (February 28, 1944).

The principle that an error in a statement of a taxpayer's income for his taxable period can be corrected within the period of limitations was announced in *Mary W. Leach*, 16 B.T.A. 781, and this was affirmed by the Circuit Court of Appeals for the First Circuit upon appeal, *Leach* v. *Commissioner of Internal Revenue*, 50 F. (2d) 371. The *Leach* case is in point, the only differences being that the interest in question was interest on a deficiency in estate tax instead of in income tax, and the correction was made at the instance of the Commissioner instead of the taxpayer. That the *Leach* case would govern unless rejected is recognized in the opinion below (R. 60):

> "We think *Leach* v. *Commissioner* supports the tax accounting theory urged by the taxpayers in the case at bar, and we shall not undertake to distinguish the *Leach* case on the ground that there it was the Commissioner, not the taxpayer, who was seeking to relate back a tax refund for the purpose of expunging a deduction which the taxpayer had taken in an earlier year. *Cf. Ross* v. *Commissioner*, 169 F. 2d 483, 492 (C.A. 1st, 1948)."

The principle became established in numerous decisions relating to deductions other than interest deductions under Section 23 of the Internal Revenue Code, which cases are of course *in pari materia*.[1] The principle upon which they

[1] *Producers Fuel Co.*, 1 B.T.A. 202 (losses); *Beacon Coal Co.*, 9 B.T.A. 280 (expenses); *Inland Products Co.*, 10 B.T.A. 235 (taxes); *Philip C. Brown*, 10 B.T.A. 1122 (taxes); *Joseph V. Horn*, 23 B.T.A. 1131 (taxes); *Elsie S. Eckstein*, 41 B.T.A. 746 (taxes); *E. B. Elliott Co.*, 45 B.T.A. 82 (expenses); *Stimpson Investment*

proceed is stated in *Stimpson Investment Corp.* v. *United States* (D.C. Mass.), 35 F. Supp. 498, where the petitioner on the accrual basis accrued, paid and deducted Cambridge real estate taxes in 1932 and recovered them in 1935:

> "It will be noted that the two year period prescribed by section 275 of the Revenue Act of 1932 had not expired when the Commissioner adjusted the 1932 return and corrected a mistake made by the taxpayer and the City of Cambridge. The result then obtained was that the assessment of taxes for the year 1932 was based upon the taxpayer's correct income."

and in *Elsie S. Eckstein,* 41 B.T.A. 746:

> "We have consistently held that where in a given year taxpayer takes a deduction which prior to the final determination of his income tax liability for such year is ascertained to be excessive, only the correct amount will be allowed in the final determination of his income tax liability."

Thus it will be seen that the principle was considered established. We submit that, unless this principle is adhered to, the right of the taxpayer to correct an error in his return by filing claim under Section 322 of the Internal Revenue Code to secure a refund of an overpayment of tax, and the corresponding right of the Commissioner to deter-

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Corp. v. *United States* (D.C. Mass.), 35 F. Supp. 498 (taxes); *The Louisa Co.,* 45 B.T.A. 1056 (undistributed profits taxes); *Bohemian Breweries, Inc.* v. *Commissioner* (Ct. Claims), 27 F. Supp. 588 (federal excise taxes); *Hoboken Land & Improvement Co.* v. *Commissioner,* 138 F. (2d) 104 (C.C.A. 3) (taxes); *Cooperstown Corp.,* B.T.A. Memorandum Decision reported in 42 C.C.H. paragraph 7575D (capital stock tax); *Cooperstown Corp.* v. *Commissioner,* 144 F. (2d) 693.

mine a deficiency under Section 271, must be clouded by qualifications for which no warrant is found in the statute.

2. Analysis of Security Flour Mills Co. v. Commissioner, 321 U.S. 281.

In *Security Flour Mills* the only issue that was presented or passed upon by the Supreme Court was whether the flour mills, which had sold flour in the year 1935 at a price sufficiently high to cover processing taxes under the Agricultural Adjustment Act of 1933, could deduct for 1935 $45,000 refunded to its customers during 1936, 1937 and 1938. The refunds were conceded to constitute ordinary and necessary business expense for the maintenance of good will, although the taxpayer was not legally obligated to make any refunds. This Court decided that the deductions could not be taken in 1935 because no obligation to make them had become fixed and permanent in that year, and, as the income was required to be stated on an annual periodic basis, an item which had not accrued in 1935 could not be deducted in that year.

We submit that *Security Flour Mills* is a reiteration of the principle announced in *Lucas* v. *American Code Company, Inc.*, 280 U.S. 445; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290; and *Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516, namely, that under the accrual system of accounting no item of income or deduction (with the exception of reserves for bad debts and depreciation) accrues until its incidence has become ascertainable and certain. All these decisions, and *Security Flour Mills* also, support the petitioners' position and the principles established in the cases discussed under point 1 by their insistence that, whether on the accrual or cash basis of account-

ing, only those deductions can be taken which are applicable to the taxable period, whether because "paid or accrued" or "paid or incurred," depending upon the method of accounting employed. In the *Security Flour Mills* case this Court was not called upon to pass on the correctness of the principle established by the cases referred to under point 1 above, and made no intimation as to the correctness of the principle.

3. A Review of Lower Court Decisions Subsequent to Security Flour Mills.

On January 19, 1944, the Court of Appeals for the Third Circuit in *Cooperstown Corp.* v. *Commissioner,* 144 F. (2d) 693, affirmed the decision of the Board of Tax Appeals as stated in the petition (*supra,* p. 6). Subsequent to the decision of this Court in *Security Flour Mills* (February 28, 1944), the Court of Appeals, in view of that decision, ordered the case to be reargued on April 3, 1944. On August 30, 1944, the Court of Appeals reaffirmed its decision, giving careful consideration to the *Security Flour Mills* case. In the second opinion the Court said:

> "In order to isolate a payment or accrual of a liability as a completed transaction in the year in which it is made or accrued, it is necessary that the taxpayer be under a legal obligation for the payment at the time it is made or accrued. . . . Where a liability for state tax rested upon a taxpayer which denied the validity of the tax and was contesting its imposition in which it was ultimately successful, the circumstance of the taxpayer's denial and contest of the liability was held sufficient to render the liability so uncertain and indefinite as to deprive the taxpayer of the right to accrue the tax in the year for which it was assessed.

See *Dixie Pine Products Co.* v. *Commissioner, supra.* No less unwarranted can be a deduction for a tax payment for which indisputably no liability existed.

"The Board having correctly concluded that the item in question was not a legally allowable deduction from the taxpayer's gross income for the year 1937, we accordingly confirm our former decision and reaffirm the decision of the Board of Tax Appeals."

On June 22, 1944, before the reargument of the *Cooperstown* case, the case of *Stanard-Tilton Milling Co.*, 3 T.C. 1026, was decided by the Tax Court. One of the issues was whether the taxpayer, on the accrual basis, could deduct in 1935 processing taxes paid by it in that year but recovered by it by way of credit against other tax liability in 1940. The Commissioner urged that the deduction should be reduced by the amount of credit, relying on *E. B. Elliott Co.*, 45 B.T.A. 82. The Tax Court rejected respondent's contention, saying merely:

"... We consider that the application of the principle of the *Elliott* case to the situation here presented is precluded by the new pronouncement of the Supreme Court in *Security Flour Mills* v. *Commissioner.*"

In a dissenting opinion, however, it was stated:

"To say that we are required to hold that amounts illegally and unconstitutionally collected as a tax are 'taxes paid' and therefore deductible because the Supreme Court has said that where there was denial of liability and contest of payment of an asserted tax there was no accrual and therefore no allowable deduction, is to me very strange reasoning."

Notwithstanding the decision in the *Cooperstown* case, *Stanard-Tilton Milling Co.* was followed in this case by the courts below and to some extent in other decisions.[2] None of the cases, however, appear to have been decided on the ground that the courts felt the principle established by the cases cited under point 1 is incorrect, but because they felt under the compulsion of the asserted effect of the *Security Flour Mills* decision. We respectfully submit that no compulsion exists, and that the suggestion that an error in a statement of income cannot be corrected in the taxable year in which it occurred (within the period of limitations) has not been passed upon by this Court but should be considered and at least authoritatively decided.

4. The Importance and Continuing Importance in the Administration of the Tax Laws of the Principle Involved.

Unless the tax accounting theory sustained by the opinion below is overturned, further confusion will be introduced into an already confused field. The decision below leaves the definite impression that even a plain error cannot be corrected in the year in which the error was made but that the correction must await the year of discovery. As will be indicated later, the same impression has been left by other courts. This is an extremely doubtful theory of tax accounting and should be passed on by the Supreme Court to facilitate the administration of the tax laws.

The problem here is not merely one arising out of the law as it affected the years 1942 and 1943, but one which will continue to plague the government and taxpayers alike until it is finally settled by the Supreme Court or Congress. The theory of tax accounting in the decision below introduces unnecessarily a distortion of income which op-

[2] *Baltimore Transfer Co.,* 8 T.C. 1; *John Fabick Tractor Co.,* (C.C.H.), 7 T.C.M. 7.

erates systematically to increase or decrease the burden of the taxpayer over that imposed by the Congressional mandate. Other things being equal, it results in the taxpayer's income being taxed in a higher bracket than normal in one year and his receiving the benefit of the corresponding deduction in a lower bracket in the other year. Thus, in the case of the shareholders in Bird & Son, inc., the tax liability of the petitioners is determined on a higher basis than that of those from whom no tax was erroneously collected or who instead of paying the tax filed petitions in the Board of Tax Appeals. Similarly, it may result in the taxpayer's income being taxed in a lower bracket than normal in one year and his receiving the benefit of the corresponding deduction in a higher bracket in the other year.

While the instant case involves a deduction, it is concerned with the same accounting principle applicable to the receipt of income considered in some of the cases set forth below. These cases hold in general that the receipt of an amount which there is an unconditional obligation to refund cannot be taxable income. Conversely, the payment of an amount which there is an unconditional right to recover should not entitle a taxpayer to a deduction. In our case the taxpayers were assured prior to the end of 1942, as a result of the final decision in the *Bass* case (which was an identically parallel case with theirs), that they were entitled to recover the interest paid in 1942. In this respect the case is like *Hurd Milling Corporation*, 44 B.T.A. 786, wherein a taxpayer was refused a deduction for taxes accrued but not paid when before the end of the taxable year it was determined with reasonable certainty that they never would have to pay.

Since the Supreme Court decisions in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417 (1932), and *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946), two conflicting lines of decisions have arisen involving the tax accounting

principle with which our case is concerned. The following cases have adopted the principle set forth in the *Wilcox* case:

> *Greenwald* v. *United States,* 57 F. Supp. 569 (Court of Claims, 1944):

Officer of corporation held not taxable on part of bonus received as result of false audits showing exaggerated profits where such part was returned to corporation in later year on discovery of falsification.

> *Wells* v. *United States,* 64 F. Supp. 476 (Court of Claims, 1946):

Officer of corporation held not taxable on advance against his share of compensation based on earnings where officer knew at time of filing return that he was obligated to refund undetermined part of advance.

> *Gargaro* v. *United States,* 73 F. Supp. 973 (Court of Claims, 1947):

Officer of corporation held not taxable on part of compensation received in 1942 based on earnings which in 1945 he refunded to the corporation because earnings for 1942 were reduced as result of renegotiation adjustments.

> *Commissioner* v. *Smucker,* C.C.A. 6, October 14, 1948, P.H. par. 72,623, affirming 6 T.C.M. 1054:

Officers of corporation held not taxable on part of bonuses received in 1942 which they were obligated to return and did return in 1942.

Kavanaugh, H. Francis, T.C. Memo, April 15, 1949, C.C.H. Decision 16,918 (M):

Income erroneously credited to taxpayer's account in 1938, reported as income by him in that year and charged back against the account in 1939, when the error was discovered, should have been corrected in the return for the year when the error was made and not for the year when the error was discovered.

On the other hand, the *North American Oil Consolidated* principle was followed in *Haberkorn* v. *United States,* C.C.A. 6, March 28, 1949, P.H. par. 72,402, wherein it was held that a corporate officer who paid a tax on a bonus which was excessive because of an incorrect computation could not obtain a refund of the tax paid on that bonus despite repayment in a subsequent year. In distinguishing the *Wilcox* case, the Court recognized conflict in the following statement:

> "We recognize that there is authority to the contrary, particularly the two cases from the Court of Claims of Greenwald v. United States, 57 F. Supp. 569, and Gargaro v. United States, 73 F. Supp. 973. . . ."

Until the conflict indicated above is settled it will be extremely difficult for both taxpayers and the government to know whether to adjust tax returns in the year in which an error occurred or the year in which the error is discovered or settled.

Furthermore, the decision of the court below should not be allowed to stand, because it is inconsistent with numerous statutory enactments in which Congress has recognized that proper tax accounting requires the adjustment in the taxable year to which the adjustments relate rather

than a later year. Internal Revenue Code, Sec. 3806 (adjustments from renegotiations and equitable readjustments of war contracts); Sec. 3807 (adjustments of excess profits tax liability); Sec. 322(b)(6) (net operating losses); Sec. 322(b)(5) (bad debts and worthless securities); Sec. 3801 (mitigation of effect of limitations provisions).

Next to the question of what constitutes gross income, hardly any question could be of greater importance to the administration of the revenue laws than the question of in what year such income and allowable deductions therefrom are to be reported.

It is respectfully submitted that this case presents an opportunity for clarification of the tax accounting theory involved which would enable both taxpayers and the Treasury Department to deal with income and deductions with needed assurance.

Respectfully submitted,

EDWARD C. THAYER,

Attorney for the Petitioners.

E. Barton Chapin,

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Of Counsel.

Appendix.

Internal Revenue Code.

Sec. 322. Refunds and Credits.

(a) Authorization.

(1) Overpayment. Where there has been an overpayment of any tax imposed by this chapter, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer. . . .

(b) Limitation of Allowance.

(1) Period of Limitation. Unless a claim for credit or refund is filed by the taxpayer within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, no credit or refund shall be allowed or made after the expiration of whichever of such periods expires the later. . . .

Sec. 43. Period for Which Deductions and Credits Taken.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. . . .

Current Tax Payment Act of 1943.

57 Stat. 126.

Sec. 6. Relief from Double Payments in 1943.

(a) *Tax for 1942 Not Greater Than Tax for 1943.* In case the tax imposed by Chapter 1 of the Internal Revenue Code upon any individual . . . for the taxable year 1942 (determined without regard to this section, without regard to interest or additions to the tax and without regard to credits against the tax for amounts withheld at source) is not greater than the tax for the taxable year 1943 (similarly determined), the liability of such individual for the tax imposed by such chapter for the taxable year 1942 shall be discharged as of September 1, 1943, except that interest and additions to such tax shall be collected at the same time and in the same manner as, and as a part of, the tax under such chapter for the taxable year 1943. In such case if the tax for the taxable year 1942 (determined without regard to this section and without regard to interest or additions to the tax) is more than $50, the tax under such chapter for the taxable year 1943 shall be increased by an amount equal to 25 per centum of the tax for the taxable year 1942 (so determined) or the excess of such tax (so determined) over $50, whichever is the lesser. . . .

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 108

ELMER H. BARTLETT ET AL., PETITIONERS

v.

DENIS W. DELANEY, COLLECTOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 16-26) is reported at 75 F. Supp. 490. The opinion of the Court of Appeals (R. 57-67) is reported at 173 F. 2d 535.

JURISDICTION

The judgment of the Court of Appeals was entered on March 23, 1949. (R. 67.) The petition for a writ of certiorari was filed on June 9, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

A taxpayer on the cash basis paid interest on a tax deficiency in 1942 and properly deducted the amount so paid in his income tax return for that year. Thereafter it was determined that the deficiency had been improperly assessed, and in 1943 the amount in question was refunded to the taxpayer and included by him in his gross income for that year. Could the taxpayer thereafter amend his 1942 and 1943 tax returns by eliminating the deduction from the former and the inclusion from the latter and, upon the basis of such recomputation, claim a refund of taxes paid on 1943 income?

STATUTES INVOLVED

Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * *

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

STATEMENT

These suits were brought for the refund of income taxes paid for the calendar year 1943 and present a common question of law. They were consolidated for trial (R. 6, 37, 51) and on appeal (R. 31).

The taxpayers were on the cash basis, using the calendar year as their accounting period. During 1937, they received certain shares of stock in Bird & Son, Inc., pursuant to a recapitalization of that company, but they did not report the value of the shares in their 1937 income tax returns. In 1942, the Commissioner asserted that these shares constituted taxable income to the recipients and assessed deficiencies in their 1937 income taxes. The taxpayers paid the deficiencies, with interest, during 1942 and claimed deductions for the interest

payments in their income tax returns for that year. (R. 11, 16.)

However, a judgment rendered in 1942 in a parallel action[1] instituted by another stockholder of Bird & Son, Inc., determined that shares such as those received by taxpayers in 1937 were not taxable to the recipients. Following that decision, the taxpayers filed, during 1942, claims for refund of the 1937 deficiencies, and in 1943 the United States refunded the overpaid tax and interest.[2] The interest refunds were reported by taxpayers as income received in 1943. Thereafter, they filed claims for refund of 1943 income taxes, contending that so long as the years 1942 and 1943 were still open for adjustment, the proper tax treatment of the transactions was to redetermine the tax for those years by expunging the "interest paid" deductions taken in 1942 and eliminating from 1943 gross income the interest refunds. (R. 16-17.)

The District Court upheld the Collectors' contention that the 1942 deductions should stand and that the interest refunds should be returned as income in 1943. (R. 18-26.) The Court of Appeals affirmed.

ARGUMENT

The Court of Appeals correctly decided the case on the authority of *Security Mills Co.* v. *Commis-*

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[1] *Bass* v. *Commissioner*, 129 F. 2d 300 (C.A. 1st).

[2] Taxpayers also received interest on the amounts refunded. These items of interest were conceded to be income in 1943 and are not in issue.

sioner, 321 U. S. 281, and there is no reason for further review.

1. The right of a taxpayer to adjust his income tax liability by a timely claim for refund is qualified by the fundamental policy of the revenue laws to impose income taxes on a yearly basis. As this Court pointed out in the *Security Mills Co.* case (pp. 286-287):

> The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."
>
> This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.

Consequently, when a deduction for interest paid is properly taken in one year, neither the taxpayer nor the Commissioner may thereafter recompute the tax for that year by expunging the deduction because the interest is refunded in a later year.

That the deductions were proper when claimed by taxpayers in 1942 does not seem to be disputed. The 1937 deficiencies having been duly assessed by the Commissioner, the obligation to pay the additional taxes and interest became fixed and certain. When taxpayers discharged their obligations by payment, they became entitled to deductions for the interest paid even though they later in the year filed claims for refund. *Chestnut Securities Co.* v. *United States,* 62 F. Supp. 574 (C. Cls.). The deductions were no less allowable in 1942 because the decision in *Bass* v. *Commissioner,* 129 F. 2d 300 (C.A. 1st), had become final in that year, effectively foretelling the subsequent reversal by the Commissioner of his action in including in taxpayers' 1937 income the stock received in the Bird & Son, Inc., recapitalization. At best, taxpayers in 1942 had only an unripened right to receive refunds, since their claims had not been allowed and suits could not yet be instituted on the claims.[3] Moreover, despite the fact that the Commissioner erred in basing the deficiencies on inclusion of the Bird stock in income, there was no assurance that taxpayers would receive refunds, since the right to recover taxes paid depends not on whether the method of determining the assessment is correct, but on whether the assessments themselves are right. *Lewis* v. *Reynolds,* 284 U. S. 281; *Reinecke* v. *Spalding,* 280 U. S. 227, 232. The

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[3] The refund claims were filed on December 1, 1942.

decision in *Bass* v. *Commissioner, supra,* decided only that the Commissioner's method of determining taxpayers' liability was wrong; it did not establish that there had been overpayments.[4] That fact could be determined only by a final audit of taxpayers' returns, and until then taxpayers could not accrue the refunds, much less treat them as having been made.

Therefore, the court below correctly assumed (R. 67) that the deductions were properly claimed in 1942. It follows that the only effect of the subsequent refunds was to require taxpayers to include the refunded interest in income for the year of receipt. *Rothensies* v. *Electric Battery Co.,* 329 U. S. 296, 298.

2. It is true that *Security Mills Co.* v. *Commissioner,* 321 U. S. 281, involved an accrual basis taxpayer and that the attempted adjustment differed in that taxpayer sought to project back a payment rather than a receipt. However, there is no difference in principle whether the taxpayer is on the cash basis or the accrual basis, or whether the adjustment deals with an outgo or a receipt of income. In either case, calculation of tax liability must be made on the basis of facts occurring in the taxable year rather than in light of circumstances arising in a later year. *Security Mills Co.* v. *Com-*

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[4] Thus, in the case of one of the taxpayers, the reduction of gross income by exclusion of the Bird stock was partially offset by additions of other items to income.

missioner, supra; North American Oil v. *Burnet,* 286 U. S. 417; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359.

Francis v. *Commissioner,* decided April 15, 1949 (1949 P-H T.C. Memorandum Decisions Service, par. 49,086), *Greenwald* v. *United States,* 57 F. Supp. 569 (C. Cls.), and *Wells* v. *United States,* 64 F. Supp. 476 (C. Cls.), cited by taxpayers (Br. 14, 15), are not inconsistent. In the first two of these cases the adjustments were based on facts as they existed in the tax year and not as a result of subsequently occurring events. In the *Wells* case, the court found that the money was paid to taxpayer as an advance, and that in consequence the "claim of right" doctrine announced in *North American Oil* v. *Burnet, supra,* had no application.

Gargaro v. *United States,* 73 F. Supp. 973 (C. Cls.), also cited by taxpayers (Br. 14), was a decision on the Government's demurrer and involved no final judgment or decree which could be reviewed. *Standard Steel Car Co.* v. *United States,* 61 C. Cls. 391. Following overruling of the demurrer, the case has been set for hearing on the merits and is now pending.

3. Taxpayers' contention (Pet. 5-6) that the decision here is in conflict with *Cooperstown Corp.* v. *Commissioner,* 144 F. 2d 693 (C.A. 3d), certiorari denied, 323 U. S. 772, amounts in essence to a repetition of the argument advanced in the petition for certiorari in the latter case that the deci-

sion there conflicted with *Security Mills Co.* v. *Commissioner,* 321 U. S. 281. As the court below pointed out (R. 66), the *Cooperstown* case is distinguishable from the *Security Mills* case and from this one for the reasons stated by the Government in opposing the petition in the *Cooperstown* case. In that case, the tax had not been assessed by the Commissioner, and demand had not been made by the Collector. The tax had been voluntarily computed and paid by the taxpayer, and it was on this ground that the right to the deduction was denied. The court held (144 F. 2d 693, 696) that in the absence of liability during the tax year, the deduction should be denied, distinguishing *Stanard-Tilton Milling Co.* v. *Commissioner,* 3 T. C. 1026, where deduction was allowed for taxes assessed and paid during the tax year although refunded in a later year. The situation here is indistinguishable from *Security Mills Co.* v. *Commissioner* and *Stanard-Tilton Milling Co.* v. *Commissioner.* It is unlike *Cooperstown Corp.* v. *Commissioner,* and the reasons for denial of certiorari in the latter case are equally applicable here.

CONCLUSION

The decision of the Court of Appeals is in harmony with decisions of this Court, and there is no conflict with other Circuits. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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JULY, 1949.

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Supreme Court of the United States.

October Term, 1949.

No. 108.

ELMER H. BARTLETT et al.,
PETITIONERS,

v.

DENIS W. DELANEY, Collector, et al.,
RESPONDENTS.

PETITIONERS' REPLY BRIEF.

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PETITIONERS' REPLY BRIEF.

1. *Hart Furniture Co., Inc.,* v. *Commissioner,* 12 T.C., No. 147, promulgated June 21, 1949. We respectfully call attention to the above decision, promulgated subsequent to the filing of the petition for certiorari, as illustrating the confusion in the cases dealing with erroneous deductions, and indicating that *Cooperstown Corporation* v. *Commissioner,* 44 F. (2d) 693; certiorari denied 323 U.S. 772, is in conflict with the decision below as we assert. In *Hart Furniture Co.* the company claimed as a deduction in 1945 the full amount of its social security taxes without availing itself of the 90% credit for contributions to the state unemployment compensation fund.

> "Not through design, but through error, petitioner, upon filing its excise tax return, failed to avail itself

of the credit to which it was then entitled, all conditions thereto having presumably been met. As a result its ultimate federal excise tax liability was erroneously overstated by about 90%, and, upon claim by petitioner, this erroneous overpayment was ultimately refunded to it in 1946. Petitioner contends that since it actually did pay $856.99 in order to meet its supposed excise tax liability, though conceding the amount was erroneous, it should be permitted to deduct that amount. Respondent on the other hand, argues that petitioner's deduction should be limited to the amount of its definitely ascertainable actual excise tax liability, i.e., the difference between $856.99 and $766.54, the amount ultimately refunded to petitioner.

"In our judgment, respondent's conclusion must be upheld. We believe the disposition of this issue in respondent's favor is compelled by *Cooperstown Corporation* v. *Commissioner,* 144 F. (2d) 693; certiorari denied 323 U.S. 772."

In the opinion reference is made to the decision below, and it is stated:

"In the *Bartlett* case, the payment of the tax, later refunded, was made pursuant to a determination of the Commissioner, and Chief Judge Magruder, writing the opinion on behalf of the First Circuit, recognized 'that the *Cooperstown* case is narrowly distinguishable on its facts.' "

2. We reiterate that *Cooperstown* is in conflict. The only grounds for distinction are that in *Cooperstown* and *Hart* the deduction was in respect of a tax overstated by the taxpayer, while in our case the overpayment was with respect to a tax erroneously determined by the Commis-

sioner. The *Cooperstown* case, we submit, does not rely on any such distinction, nor does the opinion below, R. 70. Such a distinction is pointless to the proper administration of the tax laws, when the question involved is one of substantive law, namely, what is the net income of the taxpayer for the period? See opinion of Frankfurter, J., in *Ross* v. *Commissioner,* 169 F. (2d) 483, 492 (C.A. 1st, 1948).

It is futile merely to assert, as does the opinion below, R. 70, and the brief in opposition, p. 10, that the cases are "narrowly distinguishable" or "distinguishable" without pointing out any distinction except a vague reference to reasons stated by the government in opposing the petition for certiorari in the *Cooperstown* case.

Respectfully submitted,

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